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AMERICA'S RAILWAY FALLACY

BY SAMUEL O. DUNN

THE present policy of Government regulation of railroads and other public utilities is firmly established in the United States. Most people strongly believe in it. Therefore, they will react unfavorably to an indictment charging that it is based mainly on a gross fallacy; that for this reason it has done great and unnecessary harm; and that unless it is rebuilt on a sound foundation it will in time do incalculable injury to every kind of business and every class of people in this country. It is, however, the purpose of the present article to draw and to prove an indictment making these very charges.

I do not attack all Government regulation of railroads and public utilities; but I do attack the prevalent policy of regulation as being based mainly on a wholly unsound principle, and as being not only not in the interest of the public, but a menace to the welfare of the people of the United States.

Persons and concerns in business in this country are divided by our law, as interpreted by the courts, into two classes—one composed of those that are held to render services which are “affected with a public use”; the other composed of those whose businesses are not “affected with a public use”.

Nobody questions the soundness of the distinction made by the courts. But a legal principle, and a principle of economics or public policy, are two entirely different things. Our law-makers and administrative commissions and the public have

ignored the wide difference between them; and this it is which has caused the upbuilding of our present huge system of government regulation of public service concerns upon the shifting sands of fallacy. What is this gross fallacy on which it is founded? To answer that question it will first be necessary to review certain decisions of our courts.

The Supreme Court of the United States in the "Granger" cases of the 'seventies established the principle that the States had power to regulate the rates charged by a concern engaged in a business "affected with a public use". It was later settled that the Federal Government had like power if the concern did an interstate business. No court has attempted to enumerate all the kinds of concerns that render a "public service" and whose business is "affected with a public use", but, of course, railroads and public utilities are the principal ones.

The courts made clear in these early decisions that the power of Government to regulate the rates of public service concerns grew out of the fact that these concerns were monopolistic or quasi-monopolistic in their nature, and therefore, in the absence of regulation, could and probably would charge the public excessive rates, and make exorbitant profits. The principle that Government could regulate was established to protect the public from such extortion.

The States in succeeding years passed laws drastically reducing the rates of railways and other public service concerns. The courts then established another important principle which was intended to protect public service concerns themselves from extortion by the public. They found that the rates fixed in certain instances rendered the companies unable to earn any return upon their investment. They held that this was in violation of the constitutional provisions which forbid private property to be taken for public use without due process of law or just compensation. They laid down the principle that while the rates of concerns engaged in rendering a public service were subject to regulation, they could not constitutionally be so regulated as to deprive the owners of a fair return upon the fair value of their existing property, because this would be confiscation.

Now, these decisions of the courts settled only the legal question of what the State and National Governments had power to do. They did not settle, or say, or imply, what, in the public interest, it would be wise for the Governments to do. They settled what could be done with property already in existence. They had no relation whatever to what ought to be or must be done to induce private capital to bring more of the same kind of property into existence. Courts determine questions of law, not questions of public expediency; and what ought to be done to further the interests of the public was and is a question, not of law, but of economics and public policy.

Nevertheless, most of the public and most public men, apparently without detecting any fallacy in their reasoning, jumped to the conclusion that what the courts had held was the extreme limit beyond which Government regulation of public service concerns could not constitutionally be carried, was also the very limit to which, in the public interest, it ought to be pressed. The courts had held that the rates and net return of a railway, for example, could constitutionally be reduced to the very lowest level which would not involve actual confiscation of its existing property, but no further. Our lawmakers and regulating commissions, with the sanction of public sentiment, proceeded rapidly, as a matter of public policy, to establish and build up a system of regulation, the main purpose and effect of which have been and are now to restrict the net returns of railroads to the lowest level which will not involve confiscation.

When one criticizes this policy he is invariably met with the answer that railways are engaged in rendering a public service and, therefore, ought to be so regulated. That statement expresses the great American fallacy. The courts may hold that rates which yield a net return of five or six per cent upon the valuation of a concern do not involve confiscation of its existing property. That settles the law; rates that will yield only five or six per cent may then legally be fixed and enforced. But it does not settle or have anything to do with the question of what return it is to the public interest that the concern should be allowed to earn. The Government is held by the courts to have many powers. It is held, for example, to have a practically un-

limited power to tax. But nobody ever uses the fallacious argument that because the Government's power to tax is practically unlimited it ought to impose practically unlimited taxes. Why then, say, that because the Government has the constitutional power to reduce the rates and net returns of public service concerns to a level where confiscation will be barely avoided, it is the Government's duty to the public to do this?

It is the Government's duty to the owners of the existing property of a public service concern not to confiscate it. But it is also the Government's duty to the public to follow a policy which will permit and encourage such improvement and enlargement of a public service concern's property as will enable it to render as much better and as much more service as the public needs. Now, the measure of what return will not confiscate the existing property is not, never was and never will be the measure of what return the company must earn to be able adequately to improve and enlarge its property. A return of five or six per cent may not be confiscatory of the existing property; but at the same time a return of eight or ten per cent may be necessary to enable it to raise enough additional capital to provide necessary additional service. In that case, for the Government to restrict it to five or six per cent directly injures the public, by preventing the concern from providing needed service. The fact, however, that, as a matter of public policy, any limit except that of confiscation should ever be set to regulation, has never been recognized in any regulatory law passed in this country except the Transportation Act. This act requires the Interstate Commerce Commission in fixing rates to consider the public's need for adequate transportation; but strenuous efforts are now being made to repeal even this provision on the ground that it tends to make rates high.

Let us now take up the very practical question of what effects actually have been and are being produced because those who have passed and administered our regulating laws have failed to recognize the broad distinction between (1) the way the courts have held the Government can regulate public service concerns, and (2) the way sound principles of economics and public policy dictate that it should regulate them.

On one side we have that large class of persons and concerns that are engaged in agricultural, mining, manufacturing, mercantile and financial pursuits, and that are held not to be engaged in rendering public services, and, therefore, not subject to regulation. Many of them produce commodities or render services that are necessary; but they include all those that provide us with luxuries. They include those that build passenger automobiles, those that provide "movies" and cigarettes, those that make silk shirts, jewelry, cosmetics and chewing gum. I do not mention these particular industries of luxury in any spirit of depreciation or criticism whatever, but merely as specific illustrations that throw light on our governmental policy. All these concerns that are held not to render any public service are free to add to the capitalizations of their actual investments as much water as they like. Neither Government nor public sentiment will protest. They are free to make any profit they can. It may be six per cent, or it may be 600 per cent. The more it is, the more the public admires and applauds. Some of the very largest fortunes in the country have been built up from nothing in a very few years in these industries of luxury.

Concerns not engaged in rendering a public service may pay any salaries they please. A Postmaster-General of the United States recently has accepted from the moving picture industry a salary twice as large as that paid to any railroad president in this country. One of our larger steel companies pays its president a salary greater than the combined salaries of any dozen of our railway presidents. Does not the public, when it buys the product or service of a concern that is not engaged in a public service, pay the profits it makes or the salaries of its officers, just as truly as it pays those of concerns held to be engaged in a public service?

We have looked upon that picture; now look upon this. On this side we have all those enterprises that are engaged in rendering what are called "public services": railroads, street railways, electric light and power companies, gas companies, etc. The courts held that because of their monopolistic or quasi-monopolistic nature they might charge the public excessive rates and make exorbitant profits, and that therefore they were subject to

regulation of their charges. On this foundation we have built a system of regulation which has made public service concerns, and especially railway and traction companies, the Ishmaels of the business world. We jumped to the utterly fallacious conclusion that the only way to make sure their rates always would be reasonable was to restrict their net returns as much as the courts would allow. It was decided that in order adequately to control their net returns, they must be prevented from issuing any securities except those representing actual investment. Knowing that in many instances the outstanding securities do not represent actual investment, we have developed elaborate engineering and accounting methods of evaluating their physical properties; and we exhaust our ingenuity in devising means of so regulating their rates as to keep their net returns on these valuations just as low as the courts will not hold confiscatory.

In the case of the railroads regulation originally intended merely to protect the public from extortion has been extended to almost every detail of their business, including the wages and working conditions of their employees. It has not yet reached the salaries of their higher officers; but these, although small compared with the incomes of men of equal ability and responsibilities connected with other large concerns, have become the objects of constant attack; and recently a bill was introduced in Congress to fix a maximum for railway salaries of \$15,000.

Ever since this system of regulation was put into full effect the railways and most public utilities have been earning relatively lower and lower net returns as compared with those of other important industries. Between 1910 and 1915 the net income (after paying interest and all Government taxes) of all the corporations in the United States increased one-half, while the net income of the railways declined one-third. In 1917, the last year of private operation before Government control, although the railways handled the largest business in their history to that time—a business more than one-half greater than in 1910—their net income was but one per cent greater than in 1910—and the net income of all the corporations of the United States was 160 per cent greater than in 1910! Could any statistics show more strikingly the difference in the tendencies of profits in the

railway and in other businesses both before the war and during the war years? And to-day, with the war behind us over three years, on the pretense that it is regulation in the public interest, the railways are being forced to give their employees working conditions more favorable, and wages relatively higher than those obtaining in almost any other industry, or even than obtained during the war, although at this very time the railways as a whole are earning returns much smaller than in former years and much smaller than any court ever held fair and reasonable.

What has been the effect upon the welfare of the public itself of the incorporation in our public policy of this remarkable distinction between these two classes of concerns? We have seen within recent years a remarkable expansion of concerns not engaged in rendering public services. Our mining, manufacturing and mercantile businesses have grown fully as much in proportion as in earlier years. We have seen the manufacture of automobiles grow from almost nothing into one of the largest industries in the country. A few months ago I made a careful compilation of statistics which seemed to show that in the year 1920 the people of the United States, without including their investment in highways, spent more for automobile transportation than for all their railroad transportation.

While great expansion, resulting from vastly increased investment, has been the rule in the class of industries held by the courts not to render any public service, the tendency in practically all industries which are held to render such service, and which are, therefore, subjected to Government regulation, has been in exactly the opposite direction. In the four years ending with 1912 railroad and traction companies issued four billion dollars in securities, and industrial companies less than three billions. In the four years ending with 1920 railroad and traction companies issued one and three quarter billions of securities, and industrial companies over seven billions. In consequence, there is agitation and outcry in almost every city in the country because the development of street railway lines has utterly failed to keep pace with the growth of population and traffic. Almost everywhere the cars during rush hours are overcrowded to the point of indecency and of danger to the public health.

The most striking example of all is afforded by the railroads. Their development kept pace with that of the other industries of the country until about 1910, when the present system of regulation began to be applied with its full rigor. Since that time the percentage of net return earned by them on the investment in property shown by their books has gone steadily downward; in 1921 it was the smallest in any year in the more than thirty years that the statistics of the Interstate Commerce Commission have been kept—less even than in 1894. Their development has gone steadily downward with their net return. Divide the last sixteen years into four periods of four years each, and you will find that the development of the railroads has been less in each period than in the preceding period; and in the last four years they tore up more miles of line and “scrapped” more locomotives and cars than they built.

What does all this mean? It means that as a result of the legally sound, but economically unsound, distinction that we make between concerns which do and concerns which do not render a public service, we are directly encouraging the development of many industries which are highly desirable but relatively non-essential and directly discouraging the development of industries which are absolutely essential. As a matter of public policy,—to state the facts in their baldest form,—we are encouraging the manufacture of chewing gum and discouraging the provision of electric lights and power. As a matter of public policy we are encouraging the manufacture of cosmetics and silk shirts and discouraging the provision of good and adequate street railway service. As a matter of public policy we are encouraging the increase of “movie” shows and discouraging and actually making impossible the adequate development of railways.

Could anything be more fantastic, and even mad, than a governmental policy which permits unlimited profits and large fortunes to be made in, and thereby encourages the vast growth of, industries which are relatively non-essential, and which at the same time restricts to the lowest limit permitted by constitutional limitations the profits that can be earned in, and consequently discourages or actually prevents the development of, concerns that render services that are absolutely essential to the

public welfare? Or am I wrong, and is it more essential to the public welfare for the people to have plenty of chewing gum, cosmetics, "movies," cigarettes, and silk shirts than for them to have enough street cars to ride to and from their work, enough lights for their homes and enough railways on which to ship their goods?

The country already has felt in inadequate public utility and railroad service some of the effects of the stupid distinction our Governments, for at least ten years, have been making in dealing with different classes of industries. But the effects the public has thus far felt have been negligible compared with the effects it will feel in future, unless a different policy is adopted. We are overlooking the fact that there is a vital inter-dependence between all classes of industries, and that no large group of industries can long prosper and develop unless all other large groups prosper and develop also.

The volume of commerce possible depends upon the volume of production; and the volume of production possible depends upon the amount of transportation that can be furnished. The policy I am criticizing has resulted in facilities of production and commerce expanding far more than means of transportation. Our almost unbroken experience in the four years ending with 1920 clearly demonstrated, however, to those who carefully studied the matter, that the time when our production and commerce could increase more in proportion than our means of transportation had passed. There never was a time from the beginning of the year 1917 to the end of the year 1920, except during a few months in 1919, when the railways could or did handle all the freight offered to them. The productive capacity of our industries is greater now than ever before. When general business revives our industries will offer the railways more freight to transport than ever before. Unless there is speedily an expansion of our railways much greater than now seems probable, or even possible, the railways will not be able to handle anywhere near all this business; and the amount of production and commerce we can carry on will be correspondingly restricted.

What any manufacturing plant can produce depends on the amount of fuel and raw materials that can be taken to it and the

amount of finished products that can be taken away. The size of the crops the farmers can grow is limited by the amount they can market; and they cannot market any larger crops than our means of transportation can move. As the available means of transportation determine the amount of production that can be carried on, they likewise indirectly determine the amount of commerce that can be carried on. You cannot buy and sell what cannot be produced.

Now, of course, in the long run, the amount of profits that can be made in industry and commerce depends upon the amount of things that can be produced and bought and sold. If you limit the amount of things that can be produced and bought and sold, you necessarily limit the profits that can be made in producing, and in buying and selling. The conclusion to which this reasoning leads is plain. *The governmental policy of strictly limiting the profits allowed to be made by railroads and public utilities must inevitably result, sooner or later, in limiting correspondingly the profits that can be made in all lines of industry and commerce.* The present policy of regulation is intended to enable the farmer, the manufacturer, the jobber, the merchant, to increase their profits at the expense of the railways and public utilities, and thus far it has had that result. But its ultimate effect must be to limit the profits of all these other concerns and persons as drastically as those of the railways and public utilities themselves.

Labor union leaders and persons of Socialistic tendency may not feel deep concern over this conclusion. They may fancy that the general curtailment of profits will result in higher wages and other benefits for labor. But nothing could be farther from the truth. Increases in employment and in the real wages of labor are dependent upon the expansion of production, commerce and transportation. Since this policy tends directly to restrict the expansion of production, commerce and transportation, it tends directly to reduce both the demand for labor and its real wages.

It may be said I paint too gloomy a picture—that the good sense of the American people will prevent this policy of undue discrimination by the Government between concerns rendering a public service and concerns not rendering a public service from being pursued until it has produced such results as I have antic-

ipated. But history is replete with examples of public sentiment and statesmen regarded as great having persistently given effect to policies intended to benefit the public which finally produced ruinous effects. I maintain that our present policy of so regulating railways and public utilities as to restrict them to the lowest net return that will avoid confiscation of their properties for the ostensible purpose of promoting the public welfare is one of the most flagrant examples of economic and political quackery that the world has ever seen.

I wish to emphasize again that what I have discussed is not an attack upon any class of industries or upon all Government regulation of railroads and public utilities. In some important respects railroads and public utilities are a peculiar class of business concerns; and they should be regulated to deprive them of opportunity and ability to practice extortion upon the public. What I attack is the utterly unsound theory that they should be so regulated as to prevent them from being managed according to the same general business principles as other business concerns and as to prevent them from earning ordinary business profits. The fact that they render a peculiar service and are properly subject to regulation does not in the least alter the fact that if they are to be economically and efficiently managed, their managers must be highly paid men of ability and must be allowed that wide scope for initiative and freedom of action which is essential to the successful management of every other kind of concern. The fact that they are properly subject to Government regulation does not in the least alter the fact that when other classes of business concerns must pay 6, or 7, or 10 per cent to raise new capital, railways and public utilities cannot raise new capital for a scintilla less than 6, or 7, or 10 per cent; and if they are not allowed to earn enough to pay the market rate of return they cannot raise new capital. The fact that they are properly subject to regulation does not give them any more power than other concerns to provide improved or increased service without raising and investing additional capital.

In other words, full recognition of the principle that these concerns render a service affected with a public use and are properly subject to regulation does not give them the least im-

munity from any of those economic conditions, or necessities, or disabilities, to which other kinds of business concerns are subject; and, therefore, it will always be an economic impossibility for them to increase and improve the service they render the public, unless the public allows them year by year to enjoy as great prosperity on the average as other classes of concerns.

But, it may be said, as it often is said, these concerns in rendering a public service really perform a function of government. If the Government owned and operated them it would not be under the economic necessity of deriving as large net returns from their ownership and operation as those earned by other kinds of concerns. Therefore, either their present owners should willingly accept smaller returns than those earned in other businesses, or the Government should take over their ownership and operation.

This argument for Government ownership and management has been made and answered many times, and I shall not try to answer it here, except to say that, economically speaking, it is just as good an argument for Government ownership of all industries as for Government ownership of some. One thing, however, is certain. If our policy of Government regulation is to be successful and not drive us into Government ownership, we must throw overboard forever the glaring fallacy that concerns engaged in a public service should be regulated to the point of confiscation, simply because it is not unconstitutional to do so. The constitutional power to tax is the power to destroy, but we do not therefore conclude that in the public interest the power to tax should be used to destroy legitimate businesses. The power to regulate railroads and public utilities is the power to so restrict their profits as, without confiscating their present properties, to make further expansion of these properties, and increase and improvement of the service rendered with them impossible; but the public welfare plainly demands, not that the power of government shall continue to be so used to this end, but that it shall cease to be so used.

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